Leveraging Psychological Insights to Encourage the Responsible Use of Consumer Debt

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Abstract
U.S. consumers currently hold $880 billion in revolving debt, with a mean household credit card balance of approximately $6,000. Although economic factors play a role in this societal issue, it is clear that psychological forces also affect consumers’ decisions to take on and maintain unmanageable debt balances. We examine three psychological barriers to the responsible use of credit and debt. We discuss the tendency for consumers to (a) make erroneous predictions about future spending habits, (b) rely too heavily on values presented on billing statements, and (c) categorize debt and saving into separate mental accounts. To overcome these obstacles, we urge policymakers to implement methods that facilitate better budgeting of future expenses, modify existing credit card statement disclosures, and allow consumers to easily apply government transfers (such as tax credits) to debt repayment. In doing so, we highlight minimal and inexpensive ways to remedy the debt problem.

Keywords
consumer debt, behavioral economics, psychological interventions, public policy, judgment and decision making

U.S. consumers currently hold $880 billion in revolving debt, with a mean credit card balance of nearly $6,000 (Board of Governors of the Federal Reserve System, 2014a, 2014b). The typically high interest rates on such debt can impede productive consumer spending and investment, such as homeownership. Many intractable factors, both economic (e.g., high interest rates and low wages; Zafar, Livingston, & VanDerKlaauw, 2014) and psychological in nature (e.g., scarcity; Shah, Mullainathan, & Shafir, 2012) undoubtedly contribute to this problem. However, a variety of psychological forces that are amenable to intervention also affect consumers’ decisions to take on debt. Specifically, people make erroneous predictions about future spending habits, rely too heavily on values presented on billing statements, and categorize debt and saving into separate mental accounts. The presence of these context-based psychological barriers suggests that policies designed to counter them may help ameliorate the problem.

Although there are many types of debt, we focus on revolving debt (e.g., credit cards). Given that the evidence for the success of financial education is mixed (e.g., Fernandes, Lynch, & Netemeyer, 2014), we propose interventions that are psychological rather than pedagogical in nature. (See Table 1 for a summary of these interventions as well as the barriers they are meant to overcome.)

Incorporating the Future
People have difficulties thinking about the future: They view their distant selves as strangers (Bryan & Hershfield, 2012) and fail to consider their changing tastes over time (Loewenstein, O’Donoghue, & Rabin, 2003). It is perhaps unsurprising, then, that consumers often act in ways that prioritize the present (e.g., overspend today) and leave negative consequences for the future (e.g., large debt burdens). Recent research suggests some factors that make it difficult to escape this debt cycle: People underpredict their future expenses (Peetz & Buehler, 2009, 2012) and overspend on unusual items that are often

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<th>Solution</th>
<th>Example policy recommendation</th>
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considered in isolation (Sussman & Alter, 2012). The latter is especially problematic given the large costs associated with these exceptional purchases over time. The inverse is also true: People have the tendency to overspend when they receive income that can be considered exceptional (e.g., a tax refund; Arkes et al., 1994), neglecting to realize that such frivolous spending year after year can have a significant negative effect on their overall wealth. Interventions that help people accurately understand future expenses and income may thus minimize current spending and future debt.

Given that hundreds of billions of dollars flow from the government to households annually, such transfers may be an ideal setting for policymakers to implement interventions that help people meet budgeting goals. These interventions should help consumers plan for the future by incorporating exceptional expenses into budgeting tools and spreading spending across time.

Our first policy recommendation is to match behaviorally informed budgeting tools with the receipt of government transfers. First, government should follow the lead of major financial institutions in using text messages to alert benefit recipients when the account balance associated with a transfer is low or that an unusually large transaction has been made. Second, cash transfers such as Social Security could be paired with a free app that allows individuals to monitor their spending. Most important, we suggest that any such budgeting tool (e.g., Mint.com) should include a budget category for expenses that are considered out of the ordinary. Doing so could promote accurate budgeting for a class of expenses that may be difficult to predict in isolation and even reduce spending on exceptional items (Sussman & Alter, 2012).

A second intervention would target the largest lump sum payment most American households receive each year: the tax refund. People are faster to spend windfall gains than ordinary income (Arkes et al., 1994) and are more likely to treat a single large annual payment as a windfall than several smaller repeated payments. Rather than delivering tax refunds in a lump sum, we recommend breaking up payments into multiple streams—for example, as 12 prepaid credit cards. Even if all 12 prepaid cards were delivered at the same time, dividing the payment into 12 units could imply that the refund should not be spent at once, but rather over the course of a year (Soman & Cheema, 2011). Further, because consumers save more when a tax refund is framed as a return to the status quo (i.e., “rebate”) rather than a sudden influx of money (i.e., “bonus”; Epley & Gneezy, 2007), the cards could be marketed as “rebate cards” in an effort to encourage saving.

**Improving Credit Card Statements**

Recent legislation has tried to aid consumers by providing them with more information on their credit card statements. Namely, the CARD Act of 2009 dictated that credit card statements include payment warnings detailing not only how long it would take to pay off the balance if only the minimum payment were made, but also the suggested payoff amount that would result in the credit card balance being paid off over a period of 3 years. By one estimate, the CARD Act saved consumers approximately $11.9 billion per year (Agarwal, Chomsisengphet, Mahoney, & Stroebel, 2014).

However, this additional information has the potential to influence repayment in unanticipated ways (e.g., through anchoring processes; Stewart, 2009). Indeed, aspects of the CARD Act can potentially lead customers astray: People unduly gravitate toward paying the 3-year amount rather than the minimum or the full balance (Agarwal et al., 2014), because they view this 3-year amount as a strong suggestion for what they should pay (Hershfield & Roese, 2015). This legislation helped consumers who were previously paying less than the 3-year amount but caused a reduction in the fraction of account

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**Table 1. Psychological Barriers Undermining Successful Financial Outcomes and Suggestions for Overcoming Them**

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Encouraging Debt Repayment

Prior research has demonstrated that people often create categories for money (i.e., mental accounts) and that this categorization constrains its use (e.g., saving is always the right thing to do (i.e., an injunctive norm; e.g., Cialdini, 2003)). However, many of the credits designed to promote saving could easily be expanded to provide similar tax benefits for paying down debt and could specifically target high interest consumer debt. Such policies might not only help make debt repayment easier by eliminating the seemingly trivial but meaningful barriers that make behavior more difficult (Lewin, 1951).

Summary of Policy Implications

People have a tendency to underpredict future expenses, rely too heavily on values presented on billing statements, and fail to take into account overall wealth by categorizing debt and saving into separate mental accounts. Drawing on insights from recent psychological research, we make five key policy recommendations to overcome these obstacles: (a) pair government transfers with budgeting tools that remind consumers when they are overspending relative to their own guidelines and explicitly incorporate exceptional expenses, (b) split tax refunds into separate payments, (c) revise suggested alternative payment warnings on credit card statements, (d) provide tax credits for debt repayment, and (e) allow consumers to apply government funds directly toward debt repayment. It is our hope that these suggestions will go a long way toward encouraging the responsible use of consumer debt.

Declaration of Conflicting Interests

The authors declared that they had no conflicts of interest with respect to their authorship or the publication of this article.

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Note

1. If tax refunds were directly deposited into consumers’ bank accounts, an alternative would be to implement an opt-out system in which consumers receive their tax refund via monthly direct deposits, rather than a single installment.

References


Evidence from the Survey of Consumer Finances


